IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

STROHL SYSTEMS GROUP, INC., and MYLES L. STROHL	:	CIVIL ACTION
v.	:	
WILLIAM FALLON	:	No. 05-CV-0822

J. William Ditter, Jr., S.J. September 29, 2006

MEMORANDUM AND ORDER

This is a diversity suit by a corporation and its majority shareholder against a former employee who is also a minority shareholder charging that he breached confidentiality agreements with the corporation and must therefore return his stock for one-half its current value. For the reasons that follow, I will deny defendant's motion for summary judgment and enter summary judgment in favor of the plaintiffs.

The plaintiffs, Strohl Systems Group, Inc. ("Company") and Myles Strohl[1] filed a complaint alleging two counts of breach of contract based on defendant William Fallon's disclosure of confidential information to a person unrelated to and unaffiliated with the Company in violation of an investment agreement (Count I) and a subscription agreement (Count II). The complaint seeks the following relief: 1) declarations that Fallon breached the two agreements; 2) an order requiring Fallon to sell his shares back to the Company under the terms prescribed for such a breach; 3) an injunction preventing further disclosure of confidential information and

[1] Because Strohl's interests in this litigation correspond with those of the Company, I shall refer to the plaintiffs collectively as the Company.

requiring Fallon return to the Company all confidential materials; and 4) damages resulting from the breach, including fees and expenses incurred in this litigation. Under the terms of the agreements, if Fallon is found to be in breach of the confidentiality provisions, he is compelled to sell back his shares of stock in the Company at a significantly discounted price.

Fallon filed a motion for summary judgment asserting that he did not commit a breach of confidentiality by disclosing information to the heir of a fellow shareholder because an heir is not "unrelated to" or "unaffiliated with" the Company. Fallon further argues that the Company's buy-back provision constitutes a penalty that is unrelated to any actual damages, and is therefore, unenforceable. I considered Fallon's motion and determined that summary judgment should probably be entered for the Company. As a result, I notified counsel of that determination by order dated September 5, 2006, with instructions to supplement the record with any additional evidence or arguments they deemed relevant.

On September 15, 2006, counsel for plaintiffs notified me that they did not intend to supplement the record. Counsel for the defendant supplemented the record by filing additional excerpts from the depositions of Myles Strohl and William Fallon, as well as an affidavit of Fallon filed under seal. On September 22, 2006, Fallon filed additional argument in opposition to the entry of summary judgment in favor of the Company. Having considered the entire record before me, I am satisfied that there are no material facts in dispute and that summary judgment should be granted in favor of the plaintiffs.

DISCUSSION

The facts of the case are fairly straightforward. Strohl is the chairman and chief executive officer of the Company which is in the business software and services industry. Fallon is a shareholder and former employee of the Company. At the time of his employment in December

1988, Fallon had purchased shares of the Company and entered into a subscription agreement and investment agreement. Each agreement contained provisions prohibiting the disclosure of confidential information concerning the Company.[2] The agreements also provided for remedies in the event of a breach of confidentiality. The investment agreement required a breaching shareholder to sell his shares back to the Company for fifty percent of their appraised value. The subscription agreement provided that a party in breach must indemnify the Company from and against all liability, damage, cost or expenses (including reasonable attorney's fees) incurred as a result of the breach. These provisions are clear and unambiguous as drafted and Fallon does not contend otherwise.

Fallon's employment terminated in March 2001. Although no longer an employee, Fallon retained an electronic copy of a confidential "Information Memorandum," dated June 1999, despite its highly sensitive nature. This document was clearly and conspicuously marked confidential and contained a list of Company customers, a market analysis, expansion plans, and past and future financial information. It also revealed that the Company was potentially for sale and its purpose was to aid potential investors or purchasers in their evaluation of the Company.

Fallon admits that he gave a copy of the Information Memorandum to Albert Taylor and a lawyer he was considering retaining. Taylor was the nephew and heir of a deceased shareholder, Martin Taylor. According to Fallon's deposition testimony, prior to his meeting with Albert

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[2] The subscription agreement provides in relevant part: Subscriber agrees to treat confidentiality (sic) all information concerning the Company made available to Subscriber and to refrain from disclosing any such information to any person **unaffiliated with** the Company. *See* Plaintiffs' Exhibit B, Subscription Agreement, ¶ 3(e) (emphasis added).

Similarly, the investment agreement provides: The Investors further agree that they will, during the terms of this Agreement, continue to treat such Information as confidential and will not disclose any of the Information to any party **unrelated to the Corporation**, other than in the ordinary course of business or pursuant to law, or utilize any of the Information for their personal benefit. *See* Plaintiffs' Exhibit C, Investment Agreement, ¶ 10(a) (emphasis added).

Taylor, Fallon was aware that Albert Taylor and the administratrix of Martin Taylor's estate were involved in a dispute with the Company. *Def. Ex. B, Fallon Dep*. at 79. Albert Taylor told Fallon that the estate was not getting any distributions from the Company and that he was an "injured shareholder of the corporation." *Id.* at 89-91. Taylor was aware of Fallon's termination from the Company and they discussed seeking legal counsel to pursue their claims against the Company. *Id.* at 91-92. Fallon also told Taylor that he wasn't happy about his termination, the fact that the Company was withholding distribution of monies owed to him, and that the Company had purchased a facility in a transaction Fallon did not believe benefitted all the shareholders. *Id.* at 95.

At their second meeting, Taylor and Fallon went to the law firm of Mellon Webster. *Id.* at 92. It was Fallon's understanding that Taylor was seeking counsel in an effort to obtain a higher price for the estate's shares than the Company was offering. *Id.* at 98. It was at this meeting that Fallon distributed hard copies of the Information Memorandum to Taylor and counsel.[3] *Id.* at 100-101. Although Fallon could not specifically recall telling them that the information was confidential, the document was clearly stamped confidential. *Id.* at 105.

In a phone conversation weeks later, Fallon told Taylor that he was going to proceed on his own. *Id.* at 109. He had no further "in person" meetings with Taylor but they did continue to have telephone conversations. *Id.* at 109-110. It was during such a conversation that Taylor told Fallon the estate was offered a "ridiculous" price of $300,000 for the shares. *Id.* at 110. Fallon agreed that it was an inferior offer and it was his opinion the shares were worth millions. *Id.* at 111.

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[3] Taylor also asked Fallon for the electronic version of the document but Fallon refused to give it to Taylor in that form because it could then be altered. *Fallon Dep.* at 128.

In his deposition, Fallon also discussed in some detail the nature and purpose of the Information Memorandum. It was prepared to "to entice someone to invest in the firm or buy the firm." *Id.* at 112. It provided a comprehensive overview and description of the Company. *Id.* at 113-114. Within the Company, the document was available only to Myles Strohl, his wife, Karen Strohl, and Fallon. *Id.* at 116. The document instructs that all inquiries about the Information Memorandum must be made discreetly to protect the confidential nature of the subject matter and must be directed to Fallon or Myles Strohl. *Id.* 120. It is uncontested that Fallon's initials were obliterated on Albert Taylor's copy of the Information Memorandum. Despite the admitted highly confidential nature of the document, Fallon denies ever blocking out his initials on the document or asking Taylor to do so. *Id.* at 130. Fallon believed he had the right to give Taylor this document solely because he was an heir to an estate that owned shares of the Company. *Id.* at 131.

It is also uncontested that during this period, the Company, Albert Taylor, and the administratrix were involved in litigation concerning a fair valuation of Martin Taylor's shares. In the course of this dispute, the Company provided both Albert Taylor and the administratrix with some confidential information, but not all that Fallon had provided to Taylor.

A. Was Albert Taylor "unrelated to" or "unaffiliated with" the Company?

It is undisputed that Albert Taylor has never been a shareholder or employee of the Company. His only connection to the Company was as an heir to deceased shareholder Martin Taylor. Albert Taylor never took possession of any shares of the Company, rather, before any distribution was made to the heirs, his uncle's interest was sold back to the Company by the estate pursuant to the requirements of Martin Taylor's investment agreement. Albert Taylor admits that he was aware that the Information Memorandum was confidential and he has

acknowledged removing Fallon's initials from the memorandum in an effort to conceal the source of the document. It is also uncontroverted that Albert Taylor shared this document with a variety of government officials, including the Federal Bureau of Investigation, the Internal Revenue Service, and the New Jersey state police. At some point, the shareholders were notified of the IRS's interest in the Company. *Id.* at 135.

Fallon's position, simply put, is that Albert Taylor's status as an heir put him in the shoes of his uncle and entitled him to all confidential Company information.[4] The Company argues that Taylor's status as an heir did not entitle him to anything more than the value of the shares. Under either interpretation, to establish a breach of confidentiality, the nature of an heir's relationship to the Company must be determined. Fallon's simplistic interpretation of the agreements ignores the obligations contemplated by the Company and Fallon, and it is not a logical interpretation of the agreements in view of the critical nature of the Information Memorandum.

Confidentiality provisions are designed to protect the interests of a company and address its need to keep sensitive information from falling into the hands of competitors or others, known or unknown, who might have adverse interests. What happened in this case is exactly the type of situation the provisions were intended to avoid, regardless of the Company's ability to establish actual harm and damages resulting from the breach.

It is clear that both Taylor and Fallon understood the highly sensitive nature of the document. It is equally clear that their common purpose was to hurt the Company. In fact, Taylor took affirmative steps to conceal Fallon's identity as the source of this information. This

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[4] For the purpose of deciding this motion, I assume, without deciding, that Fallon's disclosure of this document to *Martin Taylor* would not have been a breach of the confidentiality agreement because Martin Taylor was "related to" and "affiliated with" the Company.

act is revealing as to Taylor's state of mind and is inconsistent with Fallon's assertion that Taylor was entitled to the document. If they believed Taylor was entitled to the Information Memorandum, there would be no need to protect its source.

Simply being an heir to a shareholder is not sufficient to establish that Taylor was "related to" or "affiliated with" the Company. Fallon and Taylor both understood that Taylor was never going to be in possession of any shares at the time of the disclosure as the estate was already negotiating a buy-back price with the Company. It was Taylor's dissatisfaction with the negotiations between the Company and the administratrix of the estate that prompted him to contact Fallon. While confidential information could have been used to improve Taylor's negotiating position or to retaliate against the Company if things did not go as Taylor hoped, the information was not shared with the administratrix of Martin Taylor's estate, only with the FBI, the IRS, and the New Jersey state police.

Even under Fallon's construction, any relationship or affiliation between the company and an heir would cease the moment the shares were sold back to the Company. It is absurd to suggest and illogical to conclude that an heir's transient connection with the Company would confer the right to know this particular, highly confidential information when clearly anticipated, subsequent events, here the buy-back provision, would terminate that right. In this circumstance, where there was no question that the shares were going to be sold back to the Company in the manner required by the investment agreement, Fallon disclosed confidential information to someone he knew was at the very best only temporarily entitled to the information and made no effort to protect that information from further dissemination. Again, the purpose of a confidentiality provision is defeated because once disclosed, the information cannot be retrieved from someone no longer entitled to that information. Of course, when the Company elected to

disclose some otherwise confidential information to the estate's representative in an effort to negotiate a fair price for the buy-back of the shares, the Company was free to do so. In this situation, the Company was in a position to adequately protect its interests to the extent it deemed necessary by limiting access to certain information and/or by requiring the execution of a confidentiality agreement. The relevant agreements restrict the rights of the investor/employee, not the Company.

Further, under Fallon's construction of the provisions, any other heir (including minors) would also be entitled to the information. The permissible disclosure of such highly confidential information to an individual with only a temporary, perhaps fleeting, interest in the Company could not have been contemplated by the Company and Fallon and finds no support in the relevant language.

One need only review the other provisions of the agreements limiting Fallon's ability to sell or transfer his shares to another to conclude that the parties could never have understood the contracts to permit dissemination to Taylor. The agreements limit the transferability of the shares by restricting the ability of an investor to dispose of his shares and by requiring that the Company and each shareholder of the Company be given the right of first refusal to purchase any shares proposed to be sold by an investor. *See* Subscription Agreement ¶ 8; Investment Agreement ¶ 4. The Investment Agreement provides Fallon may transfer some or all of his shares to his spouse or children, but only if the recipient agrees to be bound by all the restrictions of the agreement in a form satisfactory to the Company. *See* Investment Agreement ¶ 3(a)(1). Even then the stock is deemed by the Investment Agreement to be still owned by the transferring investor. *Id.* If the Company and the non-transferring investors do not exercise their right of first refusal, no transfer of shares can be made unless the proposed transferee, in written form

acceptable to the Company, agrees to be bound by all of the restrictions, terms, and conditions of the Investment Agreement. *Id.* at ¶ 4(f).

Moreover, the type of information disclosed further establishes the unreasonableness of Fallon's position. Although Fallon takes issue with the value of this information and the confidentiality of various portions of the document, it has been established that even within the circle of the Company and its investors, only Myles Strohl, Karen Strohl, and Fallon had access to this document. The Information Memorandum was intended to entice other investors or potential purchasers of the Company and potential investors/purchasers could be required to sign a confidentiality agreement prior to viewing the document. Despite Fallon's arguments to the contrary, the tightly restricted access to this document mandates a finding that the Information Memorandum was considered highly confidential by the Company. With Fallon's specific knowledge of the contents and purpose of this document, his assertion that an heir would be entitled to its contents is utter nonsense. Given the nature of the Company's business, as well as the structure of the Company's ownership, it is impossible to conclude that these agreements permit the disclosure of highly confidential information to a shareholder's heir without the permission of the Company. In these agreements, the phrases "unrelated to" and "unaffiliated with" concern the relationship between the Company and a potential recipient of confidential information, not between a shareholder and his heir.

The Company's later release of other, less confidential information to Albert Taylor does not mean that Fallon was permitted to make such a disclosure nor does it justify what he did. Surely the Company would be expected to provide various financial documents during the course of negotiating a buy-back price for the shares. It was within the province of the Company to determine when a disclosure was in the best interests of the Company and implement any

safeguards necessary to protect its interests.

The Company's election to deal directly with Albert Taylor to further its business interests did not create any special relationship between Taylor and the Company or provide cover for Fallon's impermissible disclosure. Fallon's actions were not in the interests of the Company and did not include any effort to restrict unlimited dissemination of the information.

In summary, Fallon admits that he met with Taylor to discuss their mutual dissatisfaction with the Company and agreed to investigate possible legal action against the Company. At the meeting with counsel, Fallon distributed copies of highly confidential information to aid in potential litigation against the Company. The record requires the conclusion that Fallon's and Taylor's interests were adverse to those of the Company, and their alliance at best was motivated by their desire to promote their own interests in obtaining a better position in any negotiations with or action against the Company – at worst, was to hurt the Company. Both Fallon and Taylor believed they were not being treated fairly by the Company, and Taylor's disclosure of this information to a variety of law enforcement agencies could only be construed as an attempt to prompt a criminal investigation of the Company.[5]

B. Is the contractual remedy for breach of confidentiality a penalty?

Having determined that Fallon has committed a breach of confidentiality, I turn to

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[5] Fallon and Taylor may have been justified in pursuing legal action against the Company for their grievances, but that does not exempt Fallon from his valid contractual obligations. Nor does Fallon's state court proceeding against the Company establish that this federal action is being pursued merely to punish Fallon for asserting his rights as a shareholder.

Fallon has raised other facts he asserts are both material and disputed. I disagree and find those facts are not material. Specifically, I find that the June 2002 Confidentiality Agreement, executed in connection with discovery in the state action, has no relevance to the consideration of Fallon's earlier breach of confidentiality and does not supersede the earlier agreement. I am also unpersuaded that the Company's failure to take action against Albert Taylor or to retrieve the Information Memorandum is of any moment. Once the information had been disclosed the damage was done.

Fallon's assertion that the contractual remedy for a breach is invalid as a matter of law. Fallon claims the liquidated damages provision is an unenforceable penalty that is not calculated to compensate the Company for actual damages resulting from the breach.[6]

First, Fallon argues that Strohl's deposition testimony characterizing this clause as a "penalty" is proof of the Company's intent. He is wrong. A non-lawyer's comment about a contract term is of no legal significance in this instance. Strohl's understanding that a failure to comply with the confidentiality provision of the agreements would result in some sort of sanction (which he called a penalty) does not equal a legal admission that could support a determination that the liquidated damages provision constitutes a penalty as that term is used in the law.

Fallon also argues that this provision must be a penalty because it has no relation to any damages caused by the breach. The Company asserts that the provision is designed to protect against the wrongful disclosure of the Company's trade secrets and confidential information. The Company argues that damages for such disclosures are inherently difficult to calculate and that is was reasonable at the time the Investment Agreement was negotiated to predict that they would be catastrophic. Moreover, the Company contends that the impact of such a disclosure would fluctuate with the value of the Company, thus, a remedy tied to the changing values of shares held was an appropriate method to estimate future losses resulting from a breach.

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[6] The liquidated damages clause of the Investment Agreement provides:

> Upon the occurrence of a violation of either of subsections (a) or (b) hereof the non-violating Investors shall have the option of forcing the violating Investor to offer such Investors [sic] shares to the Corporation and the other Investors in accordance with Section 4 hereof as if such violating Investor had received a bona fide offer to purchase such shares and such Investor wishes to accept such offer. The purchase price of such offer to the Corporation and the other Investors shall be at fifty (50%) percent of Appraised Value. Such option to purchase shall be triggered by the delivery of a written notice to the violating Investor from the Corporation detailing the cause of such notice as well as the method of purchase. *See Pls.' Ex. C, Investment Agreement*, ¶ 10(c).

Under Pennsylvania law, liquidated damages clauses are generally enforceable. *Omercron Sys. v. Weiner*, 860 A.2d 554, 565 (Pa. Super. Ct. 2004). This is particularly true "in circumstances where actual damages would be difficult to estimate in advance or to prove after a breach occurs." *Pantuso Motors, Inc. v. Corestates Bank*, 798 A.2d 1277, 1282 (Pa. 2002).

Fallon argues that the assessment of damages should be tied to the nature of the breach, not the value of the breaching shareholder's interest in the Company. Fallon contends that the Company has not suffered any damages resulting from the breach, thus, an award of damages would be arbitrary and would constitute a penalty. In other words, no harm, no foul. Fallon challenges the value of the information contained in the Information Memorandum because it contained some information that was not confidential and because it was more than three years old at the time of disclosure.[7] However, Fallon also acknowledged that the document contained a comprehensive overview of the Company, that access to the document was strictly limited, and that it contained information that would be of interest to the Company's competitors. The Company responds that damages under these circumstances would be difficult to predict or assess, and the provision is reasonably designed to measure damages that might be expected for such a breach.

In *Bradford v. New York Times Co.*, 501 F.2d 51 (2d Cir. 1974), the Court of Appeals for the Second Circuit considered a similar challenge to the liquidated damages provision of an employment contract. Bradford was a former executive of the New York Times who violated a covenant not to compete by going to work for a competitor. *Id.* at 54-55. As part of his compensation plan, Bradford had received shares of Times stock that were to be distributed over

[7] Actually, the period from June 1999, the date of the Information Memorandum, through early 2002, the time of disclosure, is less than three years.

time after his retirement. *Id.* Pursuant to Bradford's employment agreement, the New York Times forfeited all of his shares of stock because of this breach. *Id.* The Second Circuit upheld the liquidated damages provision because Bradford acquired stock based upon the length of his employment and his value to the New York Times. *Id.* at 56-57.

Fallon argues *Bradford* is not controlling because the amount of his shares bore no relation to his value to the Company, and was a "mere function" of his "having committed his capital to the Company when it was a start-up." *Def.'s Reply* at 9. However, this ignores the fact that Fallon was also an employee of the Company with access to information not shared to any other employees or investors except Myles Strohl and his wife, Karen Strohl.

Courts consider whether, **at the time the contract was formed**, the remedy is reasonable in light of the probable losses resulting from a breach. *In re Plywood Co. of Pa.*, 425 F.2d 151, 155 (3d Cir. 1970). It was reasonable to believe when the Investment Agreement was negotiated that a breach of confidentiality would result in significant damages. At the time of his initial investment, the Company was a small start-up facing stiff competition. Fallon's investment was $60,000 and his buy-back after a breach would have been $30,000.

According to the Information Memorandum, in December 1998, Strohl was the majority shareholder (58 percent), Martin Taylor was the second largest shareholder (13.8 percent), and Fallon owned the next highest percentage of shares (8 percent). His position was Senior Vice President. Fallon clearly had more access to confidential information than the Company's other employees and greater access than its second largest investor, Martin Taylor, increasing the potential damage resulting from his disclosure of information. It was also reasonable for the Company to predict that as its value increased, so would the potential for damage resulting from a breach of confidentiality. Thus, as in *Bradford*, it was logical for the remedy to tie the value of

shares owned in a growing company to the estimate of probable future damages.

CONCLUSION

Having considered all evidence of record, and resolving all inferences in favor of Fallon as the non-moving party, I find that there are no issues of material fact that prevent the entry of summary judgment. Further, having concluded that Fallon's purported interpretation of the contractual language of the confidentiality provisions is absurd, I must deny Fallon's motion for summary judgment and enter summary judgment in favor of the Company.

To the extent Fallon's motion also seeks reconsideration of Rule 11 sanctions, it is summarily dismissed as untimely and otherwise without merit. An appropriate order follows.

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v.	:	
WILLIAM FALLON	:	No. 05-CV-0822

ORDER

AND NOW, this day of September, 2006, upon consideration of the motion for summary judgment of defendant (Dkt. #34), plaintiffs' response thereto (Dkt. #40), defendant's reply (Dkt. #42), plaintiffs' surreply (Dkt. #29), defendant's supplemental evidence (Dkt. # 47, 48) and brief in opposition to summary judgment for the plaintiffs (Dkt. # 49), and oral argument, IT IS HEREBY ORDERED that:

1. Defendant's motion for summary judgment is DENIED.

2. Summary judgment is GRANTED for the plaintiffs.

3. Defendant's request for reconsideration of Rule 11 sanctions is DENIED.

IT IS FURTHER ORDERED that counsel shall conduct and complete discovery concerning damages and any other relief on or before November 30, 2006. A hearing related to damages and other relief shall be held on Thursday, December 14, 2006 at 10:00 a.m. in a courtroom to be assigned.

BY THE COURT:

/s/ J. William Ditter, Jr.
J. WILLIAM DITTER. JR., S.J.